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"I Owe My Soul to the Company Store"*

History is often misused to support particular policy positions. For example, international rules prohibit employers from paying wages by issuing scrip that workers use to buy goods at a "company store" run by the employer. This ban is justified on the grounds that when this practice was used by mining companies in the nineteenth and early twentieth centuries, it allowed the companies to exploit workers. The historical evidence does not support this interpretation, however. It shows that company stores actually enabled workers to buy on credit at better terms than they could get elsewhere. Banning such arrangements is an example of restricting workers' freedom to contract; such measures, while well-intentioned, can hurt the people they are intended to protect.

In the old Merle Travis ballad *Sixteen Tons*, the miner laments that each day he gets into deeper debt with his employer. "Saint Peter, don't you call me 'cause I can't go—I owe my soul to the company store."

Company stores were common in mining towns before World War II. They were often used to pay wages in kind rather than in cash to workers who needed advances before payday. Typically a company would issue scrip (a piece of paper or a metal token) that could be used by employees to buy goods only at a store operated by the company. The popular view that this system exploited workers led years ago to international regulations restricting the use of scrip, as part of a wider effort to protect labor. That such arrangements are still used in many developing countries today, despite these rules, fuels demand for better enforcement of international labor laws. However, recent scholarship on mining communities in the United States suggests that, rather than exploiting workers, the scrip system was an improvement over the alternatives then available to workers.[1]

History has often been used to justify one policy or another. The past is rich in examples which policy makers mine for evidence to support their stand. But history can be misused. In the case of present international restrictions on scrip in developing countries, my research shows that historical evidence does not support these rules which were imposed in the name of labor protection.[2]

State intervention to protect workers is, of course, nothing new. For centuries, governments have regulated the relationship between workers and employers. Almost every aspect of the employment relationship has been put under state scrutiny: wage rates, hours worked, as well as working and pay conditions.

Early regulations did not affect only free laborers. Laws in the New World colonies in the sixteenth and seventeenth centuries, for example, specified minimum food requirements and transoceanic shipping conditions for slaves. These regulations were instituted, however, to protect the interests of the slave owners, even if slaves benefited to some degree; slave owners wanted assurance that the "property" they bought would be in good condition. Similarly, regulations that applied to indentured servants were largely designed to benefit their employers.

Modern national laws dating from the 1800s were intended, however, to benefit the working population, and were opposed by many employers. With the creation of the International Labour Organization (ILO) in 1919 came international labor conventions, which signatory countries are obligated to follow. Among these ILO standards is the restriction on scrip.

While well-intentioned, national and international regulations to protect labor can sometimes be counterproductive when they reduce the freedom of contract between the workers and employers. By preventing free exchange between two parties, regulations can make the people they are supposed to protect worse off. The ILO restriction on scrip is one example of well-meaning labor policies that may result in negative unintended consequences.

Prohibiting Scrip

The ILO convention permits national laws and collective agreements to allow for a portion of workers' wages be paid in kind, but it prohibits *individual* workers from making private agreements with their employers to take wages in noncash substitutes (ILO Convention 95, Article 4). It argues that free contracting between an individual worker and boss cannot be fair exchange. "[W]henever wage conditions, such as payment in kind…are left to be freely determined by the two parties in the employment relationship, there is a real risk of abuse, since the employee is generally in a weaker position."

The ILO looks to history for supporting evidence that the practice of paying wages in kind hurt workers. It points to the case of the "truck system," the name for the in-kind payments system used in Britain in the nineteenth century. Critics say British firms used it to underpay workers, by forcing them to take compensation in the form of goods sold by company stores at very high prices.

Under this institution, workers who need money before payday could seek an advance by taking scrip. (If they waited until payday, they received cash.) Hence, truck was a form of credit, and workers could decide individually how much of their wage was paid in kind by deciding how much scrip to request.

This arrangement is still practiced today in many developing countries in Africa, Eastern Europe and Latin America.

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[1] See Price Fishback, Soft Coal, Hard Choices, New York, NY: Oxford University Press 1992.

[2] Elaine Tan, "Regulating Wages in Kind: Theory and Evidence from Britain", forthcoming in the Journal of Law, Economics and Organization.

These countries are technically in violation of the ILO convention, to which they are signatories. The prohibition on most types of payment in kind is justified not on the basis of proven harm in these countries, however, but on the basis of something that happened more than a hundred years ago.

The Historical Evidence

As in the United States, British company stores of the nineteenth century were mainly run by mining companies in remote communities. Such stores were a convenience both for workers' families as well as for companies, which relied on them as an incentive to attract labor.

Did the British truck system, in fact, exploit workers? If it did, then the ILO policy could help workers in developing countries today avoid the same maltreatment. If it did not, then the empirical grounds of the current ILO policy are shaky.

Critics of the truck system tend to assume that the alternative to scrip was an equivalent cash wage that could be spent anywhere rather than only at a company store. The alternatives actually available to workers, however, were different: they could buy on credit from non-company stores, or make do with nothing until payday. Employers paid cash wages only on payday; workers who needed to buy goods before then had to borrow. The lender was either the company (through its scrip and company store) or a private store. My research compares the cost of obtaining credit from each.

Using company store receipts, I found that the maximum additional cost of buying goods on credit at a British company store was 8.5 percent in 1853 and 11.6 percent in 1871. In other words, it cost workers 8.5 percent more to buy goods with scrip at a company store than to buy the same goods with cash at a store not owned by the company. This extra charge is essentially what workers paid for using the credit service provided by the employers.

On the other hand, if the miners had purchased goods *on credit* from other, non-company shops, they would have paid about 25 percent more than the cash price, according to price lists from those shops. Thus, eliminating truck (*i.e.*, scrip) would have forced British miners to borrow at a higher cost.

The difference in costs reflects the better information that employers as lenders have over private lenders. Employers are better able to see if workers can repay loans, and can thereby offer better terms, than other lenders. They were also providing a service to employees. They could still do this today, although many companies no longer do so due to the ILO regulations.

Prohibiting firms in developing countries from lending to their employees through company stores hurts workers, because it may compel them to borrow from other lenders who charge more. These workers may then have to "owe their souls" to private stores or moneylenders, from whom credit is much more expensive.

Conclusion

Good intentions do not a good policy make. As with foreign aid, international measures taken to ease the suffering of the poor in less developed countries can sometimes have the opposite effect. This is especially likely when policy makers neglect the study of historical circumstances and institutional conditions, even as they appeal to history to justify their policies. Rules that undermine the individual's right (and according to Adam Smith, the individual's "natural propensity") to trade and exchange will inevitably hurt society. Prohibiting wage payment in kind undermines the freedom of contract, and workers around the world will be better served if they can choose freely with whom they wish to transact. ❑

BUSINESS-CYCLE CONDITIONS

The weaknesses among the leaders earlier this summer may turn out to be a temporary interruption of their upward trends.

Although a significant amount of uncertainty remains as to the direction of the economy in the coming months, some grounds for optimism are evident. The latest base data for eight of our twelve primary leading indicators increased, and the moving averages for eight of the series rose. Despite this good news, however, the percent of leaders expanding remained unchanged.

Only one of the twelve leaders reached a new high this month—*new orders for nondefense capital goods*. Year-to-date the series increased 16.9 percent, based on strong demand for aircraft, computers and electronic products, and industrial machinery. The series is clearly expanding.

The employment situation continues to improve. The *average weekly initial claims for state unemployment insurance* fell to 316,500 in July, which is quite remarkable given that the civilian labor force is some 150 million strong. The series, inverted for analysis, remains appraised as clearly expanding. The *average workweek in manufacturing* remained unchanged for the second consecutive month, at 40.4 hours. Although the series is clearly contracting, it remains above its recessionary trough. Manufacturing overtime increased 0.1 hour to 4.5 hours.

New housing permits was restored to clearly expanding in last month's review after being downgraded in June. Building permits in July increased 1.6 percent to a seasonally adjusted annual rate of 2,167,000—a new high. Readers of these *Reports* know that for some time we have noted that activity in the housing market has been exceptional, but at what point it becomes unsustainable is far from clear.

The National Association of Realtor's "Housing Affordability Index" is useful for gauging potential demand in the housing sector. It measures whether a "typical family can qualify for a mortgage on a typical home." Specifically, a value of 100 means that a family earning the median income has *exactly* enough income to qualify for a mortgage on a median-priced home, assuming a 20 percent down payment. Higher values imply the family is more able to afford the median priced home. The HAI has fallen steadily from October's reading of 133.3 to 117.1 due to higher home prices, moderate income growth, and rising interest rates. More revealing, as the table below shows, are the differences among regions as of June.

Higher sales coupled with a dramatic runoff in inventories led to a sharp increase in the *ratio of manufacturing and trade sales to inventories*. This development reversed the previous trend over the past several months in which inventories grew faster than sales. Whether the manufacturing sector is in balance is not completely clear, however, as the series remains probably expanding.

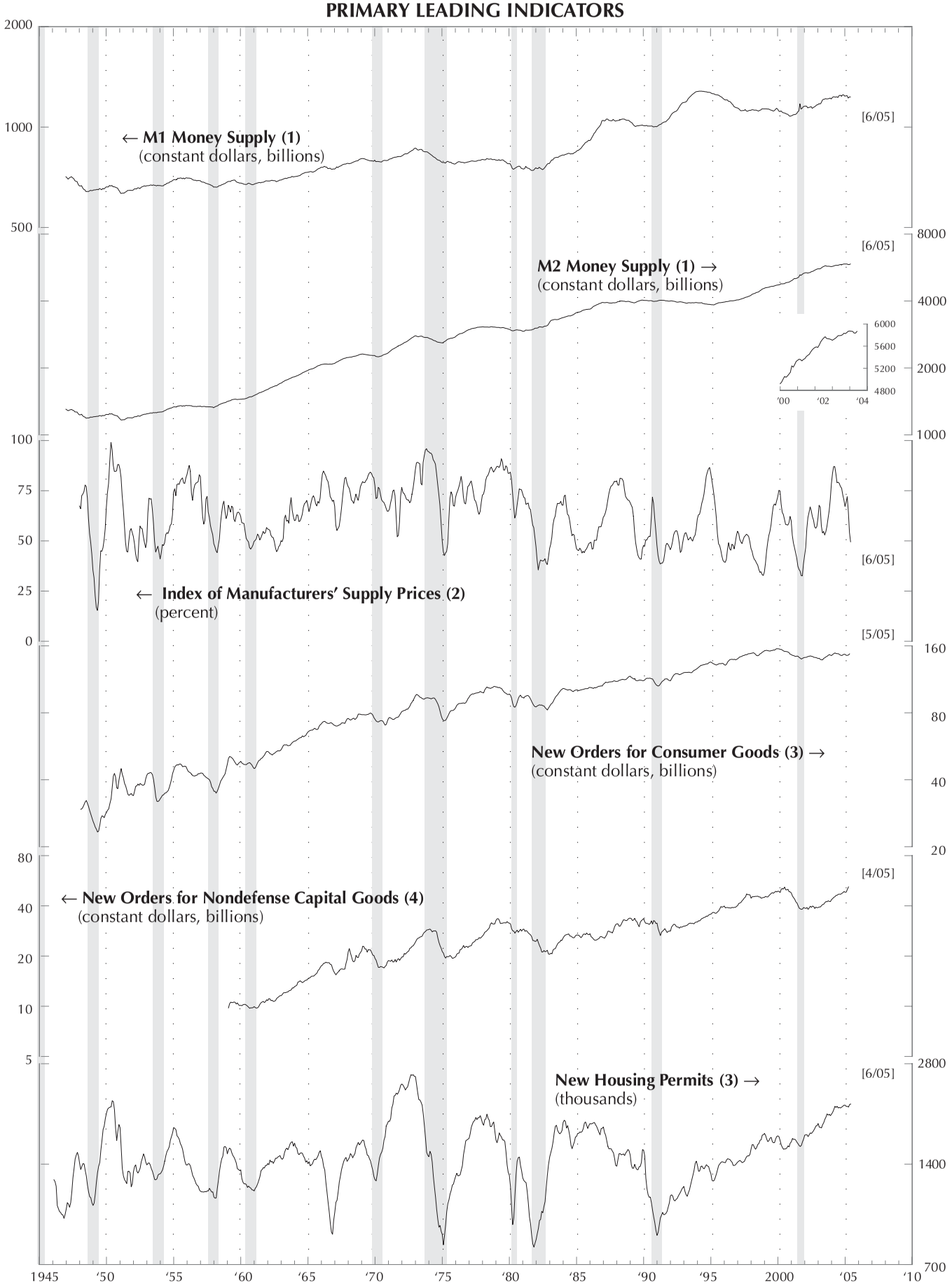
Our other manufacturing-related indicators raise additional questions about the health of the sector. The base data for both series from the Institute for Supply Management decreased in July. The *index of manufacturers' prices*, which measures the percentage of supply managers pay-

National Association of Realtors Housing Affordability Index

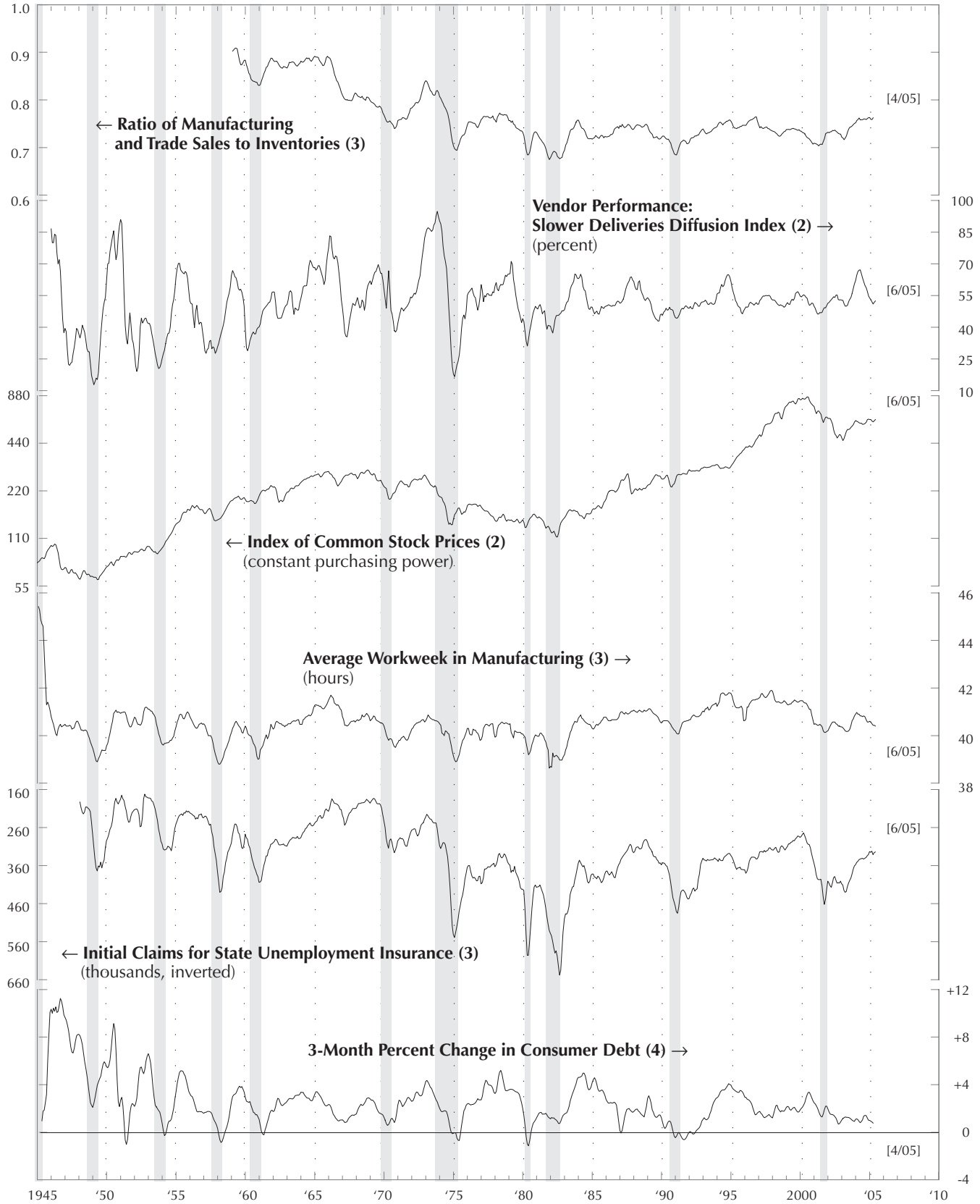
	This Month	*Month Ago*	*Year Ago*
Northeast	114.6	114.3	123.1
Midwest	154.4	159.5	161.2
South	121.1	129.1	120.6
West	80.8	84.2	89.3
National	117.1	123.3	123.7

Source: National Association of Realtors.

PRIMARY LEADING INDICATORS

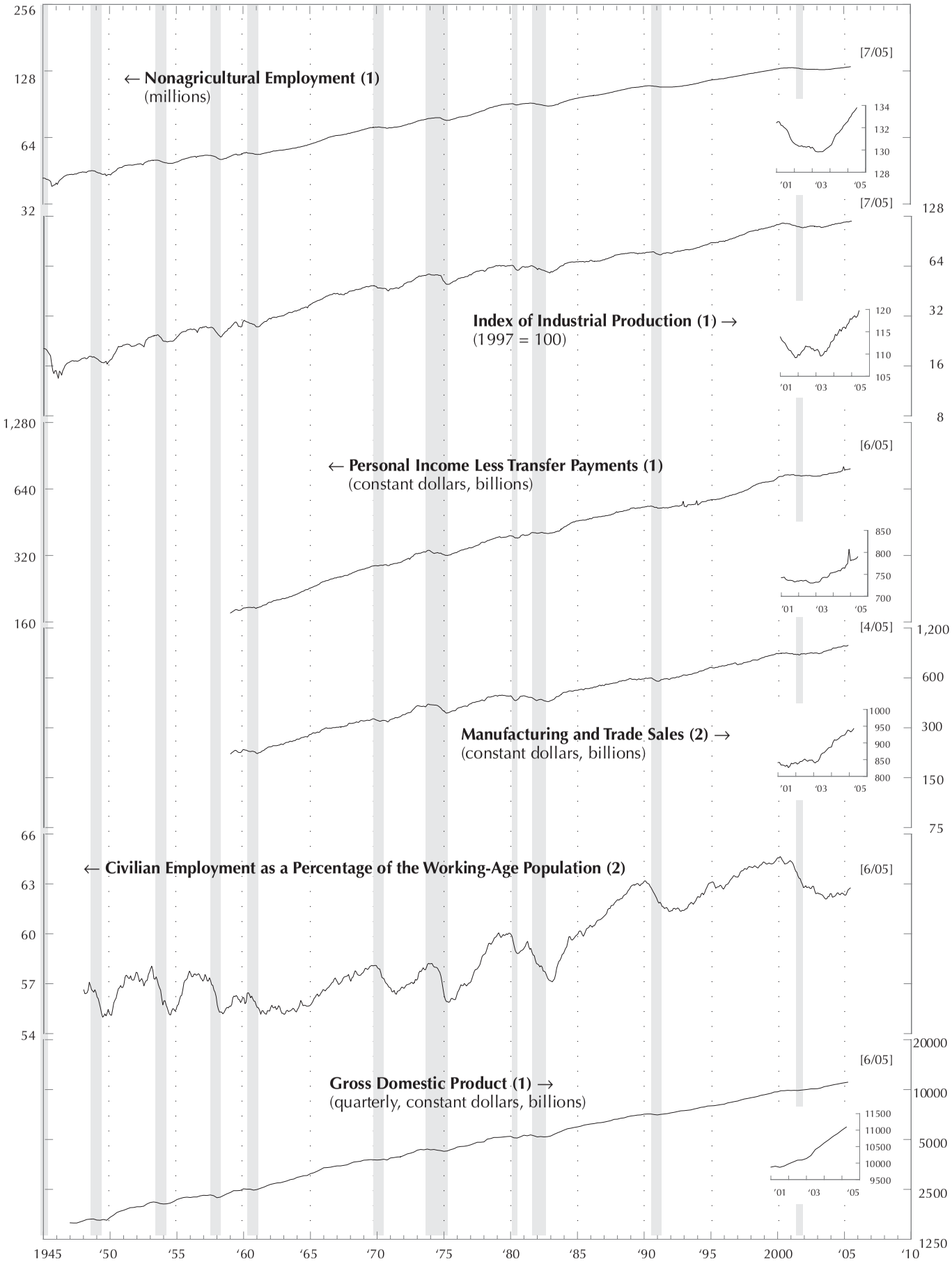


PRIMARY LEADING INDICATORS (Continued)

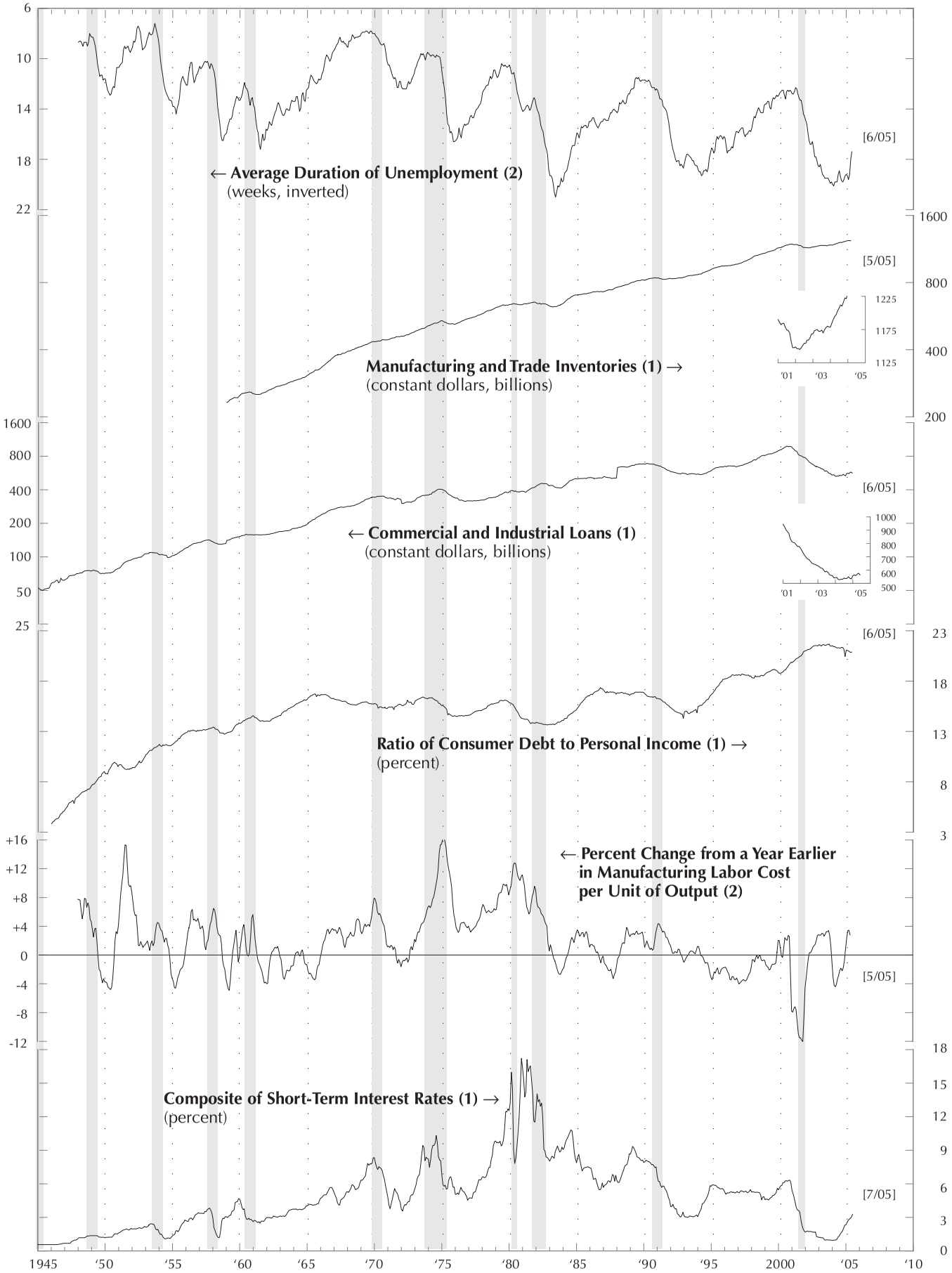


Notes: 1) Shaded areas indicate recessions as dated by the National Bureau of Economic Research. 2) The number in parentheses next to the name of a series is an estimate of the minimum number of months over which cyclical movements of a series are greater than irregular fluctuations. That number is the span of each series' moving average, or MCD (months for cyclical dominance), used to smooth out irregular fluctuations. The data plotted in the charts are those MCDs and not the base data. The number in brackets is the latest month for which the moving average is plotted. 3) The insets in selected charts show recent trends more clearly. These insets have arithmetic scales, even when the main chart is plotted on a ratio scale.

PRIMARY ROUGHLY COINCIDENT INDICATORS



PRIMARY LAGGING INDICATORS



ing higher prices for inputs, is 14 months from its latest peak and is appraised as clearly contracting. Industries using steel and energy, however, reported paying higher prices. *Vendor performance,* the percentage of purchasing managers reporting slower deliveries, decreased slightly to 52.5 percent. Although the series remains appraised as probably contracting, 86 percent of manufacturers indicated that suppliers' deliveries continued at about the same rate as in June.

The *change in consumer debt*, which was downgraded last month from indeterminate to probably contracting, decreased again in June. The series is now seven months from its latest peak, but has not weakened sufficiently to downgrade it further. Consumer debt has grown at an unusually slow pace throughout the current expansion, as is evident from the accompanying historical charts.

Our three financial series are sending mixed signals. The constant-dollar *index of 500 common stock prices* increased in July, but not by enough to develop a clear cyclical trend. *M1 money supply* decreased slightly in July. Decreases in demand and other checkable deposits throughout 2005 tended to offset the modest increases in currency holdings, ultimately weakening the series until it was rendered cyclically indeterminate—its current status. *M2 money supply* is also indeterminate. The series has undergone two downgrades in recent months, due to the decline in M1 (a component) and the continued decline in retail money market funds. M2 also remains indeterminate.

Overall, fifty percent (four out of eight) of the leaders for which a trend is evident are expanding. Taken alone, this suggests the likelihood of a recession during the next few months is equal to that of continued expansion. But with four leaders indeterminate and some doubt regarding the status of three others—that conclusion may be misleading. Thus, our cyclical score may be useful.

The cyclical score, AIER's purely mathematical assessment of the leaders, complements the percent-expanding series in several ways. First, the score considers all twelve indicators, including those with no identifiable trend. Also, since it is based on the magnitude and duration of the reversals of each individual series' most recent trends, it allows for something other than an all-or-nothing contribution of a given series to the final assessment. This month's cyclical score of 58 does not suggest that recession is imminent.

Hitting on all Cylinders

The roughly coincident series continue to send strong signals. The broadest measure among the group, *gross domestic product*, increased at a seasonally adjusted annual rate of 3.4 percent in the second quarter after increasing 3.8 percent in the first quarter. GDP remains appraised as clearly expanding. Consumer spending, exports, and business investment accounted for the majority of the latest increase.

Revised estimates indicate that the current expansion is slightly weaker than originally reported. Using newly available and more comprehensive source data, the Bureau of Economic Analysis now estimates that GDP increased at an annual rate of 3.1 percent from the cyclical trough in the third quarter of 2001 through the first quarter of 2005—not 3.4 percent as previously published.

Industrial production increased 0.1 percent in July after posting a 0.8 percent gain in June. Although the series reached a new high and has a well-established upward trend, just over half of all industries reported increased production (over six month spans) in June, down from 62 percent six months earlier.

Hiring remains brisk. *Nonagricultural employment* grew by 207,000 in July, reaching yet another new high. Moreover, 65 percent of industries reported job gains (over six-month spans). The other labor market indicator among the coinciders, the *civilian employment to population ratio*, also increased to a new high. Both series are clearly expanding.

Both *manufacturing and trade sales* and *personal income less transfer payments* increased in June. The former series reached a new high, warranting an upgrade in its cyclical status to clearly expanding. The latter series, although not at a high for the cycle, is also appraised as clearly expanding.

With this month's changes, all of the coinciding indicators are clearly expanding. Five are at new highs, and if not for the spike in the personal income series attributed to the Microsoft dividend earlier in the year, all six would be. In short, the economy is currently "hitting on all cylinders."

No expansion-thwarting bottlenecks are apparent among our laggers. As the accompanying historical chart shows, the *average duration of unemployment* (inverted) reached its trough long after the current expansion began and only recently has begun to strengthen. This month the series reached a new high for the cycle and is now appraised as clearly expanding. However, the *average* duration of unemployment (17.6 weeks) is nearly

Statistical Indicators of Business-Cycle Changes

Change in Base Data					*Cyclical Status*		
Apr.	*May*	*Jun.*	*Jul.*	***Primary Leading Indicators***	*Jun.*	*Jul.*	*Aug.*
-	+	-		M1 money supply	?	?	?
-	-	+		M2 money supply	?	?	?
-	-	-	-	Index of manufacturers' supply prices	-	-	-
+	+	+		New orders for consumer goods	-?	?	?
+	+	-		New orders for nondefense capital goods	+	+	+
+	-	+	+	New housing permits	+?	+	+
+	+			Ratio of manufacturing and trade sales to inventories	+?	+?	+?
-	-	+	-	Vendor performance	-	-?	-?
-	+	+	+	Index of common stock prices (constant purchasing power)	?	?	?
+	-	nc	nc	Average workweek in manufacturing	-	-	-
+	-	+	+	Initial claims for unemployment insurance (inverted)	+	+	+
-	-	+		Change in consumer debt	?	-?	-?
				Percentage expanding cyclically	*50*	*50*	*50*
				Primary Roughly Coincident Indicators			
+	+	+	+	Nonagricultural employment	+	+	+
-	+	+	+	Index of industrial production	+	+	+
+	+	+		Personal income less transfer payments	+	+	+
+	+			Manufacturing and trade sales	+?	+?	+
+	+	+	+	Civilian employment to population ratio	+	+	+
+	+	+		Gross domestic product (quarterly)	+	+	+
				Percentage expanding cyclically	*100*	*100*	*100*
				Primary Lagging Indicators			
-	+	+	-	Average duration of unemployment (inverted)	+?	+	+
-	-			Manufacturing and trade inventories	+	+	+?
+	+	-		Commercial and industrial loans	+	+	+
-	-	+		Ratio of consumer debt to personal income	-	-	-
+	-	-		Change in labor cost per unit of output, manufacturing	+?	+?	+?
+	+	+	+	Composite of short-term interest rates	+	+	+
nc No change.			r Revised.	*Percentage expanding cyclically*	*83*	*83*	*83*

Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

twice the *median* duration—due to the large number of persons jobless for an extended period of time (27 weeks and over).

After reaching new highs last month, both *commercial and industrial loans* and *manufacturing and trade inventories* decreased. The decline in C&I loans was not enough to downgrade the series from clearly expanding. According to the Federal Reserve's July survey of lending practices, loan officers reported stronger demand and a further easing of lending standards and terms for C&I loans. In contrast, the sharp drop in inventories, attributable in part to the dramatic increase in motor vehicle sales associated with "employee discount" promotions, did call for lowering the series to probably expanding.

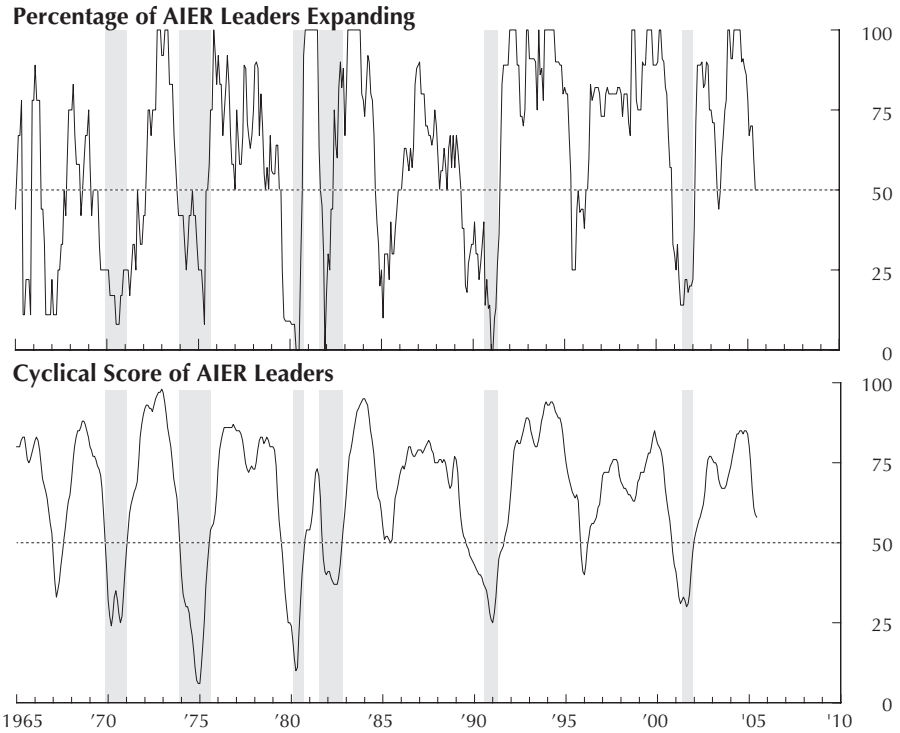
The *12-month change in manufacturers' labor cost per unit of output* decreased slightly, but continues to be appraised as probably expanding. Prior to every previous postwar recession, unit labor costs have increased. The composite of short-term interest rates increased to 3.26 percent in July, and is expected to continue to rise. (The Federal Reserve's action on August 9 to raise its target for the Federal funds rate to 3.5 percent will be reflected in our September review.) A slight increase in the *ratio of consumer debt to income* this month did not raise doubt about the series well-established downward trend—it remains clearly contracting.

Despite the downgrade in inventories, 83 percent (five out of six) of the lagging indicators are expanding, unchanged from last month. Few signs of overheating appear—as a quick look at the six charts on page 94 shows. Except for the consumer debt to income ratio and labor cost series, the other laggers are well below their highs associated with the 2001 recession.

Interest Rates: The Shrinking Gap

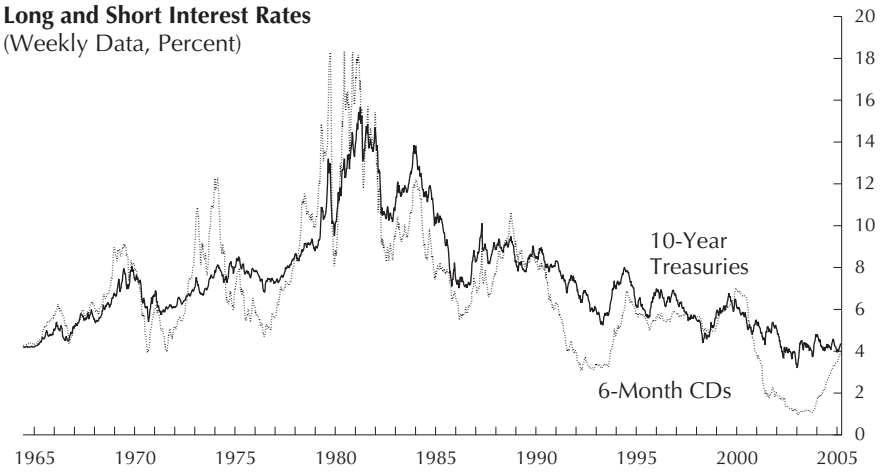
Long-term interest rates usually are higher than short-term rates, reflecting the fact that long-term investors expect greater compensation for tying up their funds for a longer period. The opposite situation—when short-term rates exceed long-term rates—occurs only rarely. Often it is a harbinger of an economic slowdown or recession.

As can be seen in the accompanying chart, the gap between long and short rates has shrunk dramatically during the past year. Short-term rates began to increase markedly after June 2004, when the Federal Reserve began raising the Federal funds rate. The rate on 6-month certificates was 3.9 percent in mid-August, up from 1.2 percent in the spring of 2004.



Long-term rates, however, have hardly changed. The rate on 10-year Treasury securities, for example, has fluctuated between roughly four and 4.75 percent. At 4.3 percent in mid-August, it was a bit higher than it was a few months ago (3.9 percent) but lower than it was in June 2004 (4.8 percent).

The combination of increased short-term rates and flat long-term rates has narrowed the gap between 10-year Treasuries and 6-month to less than half a point. The reward for lending long is much smaller now, relative to lending short, than it was a year ago. But the risks may not be. As we have reported time and again, locking-in to long-term fixed-dollar investments (especially with modest yields) exposes the holder to the ravages of inflating—namely reduced purchasing power of both the principal and interest of the holding. ❑



PRICE OF GOLD

	2003	2004	2005	
	Aug. 21	Aug. 19	Aug. 11	Aug. 18
Final fixing in London	$363.30	$406.50	$440.75	$439.65

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